CHAPTER 1

THE UNITED STATES–CHINA TRADE AND ECONOMIC RELATIONSHIP

SECTION 1: THE U.S.–CHINA TRADE AND ECONOMIC RELATIONSHIP'S CURRENT STATUS AND SIGNIFICANT CHANGES DURING 2008

The legislation passed by Congress in 2000 to establish the Commission sets forth specific topical areas of concern with respect to the People's Republic of China and associated issues and requires the Commission to investigate and report to Congress on those topics. Congress has modified those topical areas in the intervening years. Today there are eight mandated topics. (They can be found at 22 U.S.C. 7002 and at the Commission's Web site—www.uscc.gov. They also are printed in full in appendix I of this Report, beginning on page 349.) At the beginning of each section of this Report, the mandated topical area (or areas) that section addresses is identified.

"The Commission shall investigate and report exclusively on—

. . .

"WORLD TRADE ORGANIZATION COMPLIANCE—The compliance of the People's Republic of China with its accession agreement to the World Trade Organization.

"ECONOMIC TRANSFERS—The qualitative and quantitative nature of the transfer of United States production activities to the People's Republic of China, including the relocation of high technology, manufacturing, and research and development facilities, the impact of such transfers on United States national security, the adequacy of United States export control laws, and the effect of such transfers on United States economic security and employment. . . ."

Introduction

At the beginning of 2008, with its economy growing at around 10 percent a year despite global economic turmoil, with foreigners still clamoring to invest there, and with exports booming, China's economic prospects seemed assured. But then came a surge in global commodity prices that put China at risk of inflation in such core areas as food and fuel. A plunging Shanghai stock market added to the uncertainty during the summer, followed by increased anxiety that the subprime mortgage difficulties in the United States eventually would diminish America's appetite for Chinese exports. By the fall, these fears seemed borne out. In its bleakest forecast in years, the International Monetary Fund (IMF) said the global downturn will weaken growth in emerging economies, though those economies still will drive global growth. In the first nine months of 2008, China's economy expanded by 9.9 percent. Overall, China's economic growth rate is expected to slow from 11.9 percent in 2007 to 9.7 percent in 2008.[1] China's exports, however, continued to grow.

Still, despite Shanghai's stock market plunge, and indications that Shanghai is suffering from its own real estate bubble, China overall appears more capable than other nations of weathering the global financial storm that first swept over Europe, Japan, Australia, and the United States in the late summer and fall of 2008. China's domestic savings rate is among the highest in the world, providing China's banks with all the capital they need. In fact, until China's central bank joined those of 21 other nations in cutting short-term interest rates in early October 2008, the People's Bank of China had been raising rates to tamp down inflation brought on by too much liquidity in China and rising prices for imported commodities such as oil. "The urgency for fiscal and monetary easing is less pressing in China relative to the rest of the world as growth slows, not slumps, while financial sector risks are more modest owing to high saving rates, low loan-to-deposit rates, and a government able and willing to recapitalize the country's largest commercial banks," noted Ben Simpfendorfer, an economist with Hong Kong's branch of the Royal Bank of Scotland.[2]

Beijing has been able to fall back on its economic record and argue to the Chinese people that the Chinese Communist Party (CCP) alone can continue to lift the world's most populous country from rural poverty to a place among the world's leading nations. The dramatic changes in the world economy, however, will require a difficult balancing act. Too quick a restructuring of China's domestic economy will jeopardize the employment prospects for millions; too slow a change will hinder economic growth. While Chinese officials say they plan to speed up the reorganization of China's state-owned sector through mergers and asset sales in order to boost efficiency and profits, the same officials are intent on maintaining state ownership and control over a dozen key sectors, including energy and natural resources, telecommunications, and aerospace, that are deemed too important to turn over to private or foreign hands.* The state still directly controls about 40 percent of China's economy and indicates that it will continue to do so, especially through state-owned and state-controlled enterprises and other favored industries.

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*China regards seven industries as critical to national security and economic prosperity and therefore places them under absolute state control. These "strategic industries" are armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, civil aviation, and shipping. China also has designated five "heavyweight industries"—machinery; automobiles; information technology; construction; and iron, steel, and nonferrous metals—in which enterprises can be owned jointly by private and government actors, with the government retaining oversight.

The widespread intervention in the market by China's government, and an array of trade-distorting measures, undermine China's integration into the global economy—violating terms to which it agreed when it acceded to membership in the World Trade Organization (WTO) in 2001. Lack of transparency in its regulatory processes, continued protection and promotion of domestic industries to the disadvantage of foreign competition, import barriers, export preferences, and limitations on foreign direct investment in certain sectors make it difficult for foreign firms to operate in China.[3]

China's advance onto the world stage as a global economic power has been accompanied by a new willingness to play a larger role in global economic decision making, but it remains to be seen how China will attempt to wield its influence. First signs of a new kind of assertiveness, however, were seen during the Doha Round of World Trade Organization negotiations in July 2008, as China joined with India to strongly oppose initiatives from the United States and Europe—a move that helped to derail the talks.

Trade Relationship

Even with the global credit crunch, worldwide price fluctuations in oil and other commodity markets, and a confidence-shattering bust in the Shanghai stock market, the Chinese economy has slowed down in 2008 much more moderately than the economies of the United States or European nations. China has enjoyed one of the biggest export booms in modern history, with a global trade in goods surplus of over $316 billion in 2007, an increase of more than 20 percent year-on-year.[4] In 2007, China's exports to the United States were five times the amount of its imports: China exported $321.69 billion of goods to the United States and bought $65.07 billion in imports from the United States, which left the United States with a bilateral trade deficit of $256.61 billion.[5] There are some signs the size of the U.S. deficit with China may grow at a slower pace due to the U.S. economic slowdown and higher transportation costs, among other factors. For the first eight months of 2008, China's goods exports to the United States were $217.3 billion, while U.S. exports to China were $49.6 billion, with China's trade surplus standing at $167.7 billion, an increase of 2.4 percent over the same period last year ($163.8 billion).

U.S.-China Trade in Goods ($ in billions), 2000–2007

	2000	2001	2002	2003	2004	2005	2006	2007
U.S. Exports to China	16.14	19.11	22.04	28.29	34.64	41.80	55.04	65.07
Percent Change	23.21%	18.38%	15.34%	28.34%	22.45%	20.68%	31.67%	18.23%
U.S. Imports from China	100.11	102.40	125.32	152.67	196.97	243.89	288.13	321.69
Percent Change	22.38%	2.29%	22.38%	21.83%	29.02%	23.82%	18.14%	11.65%
Balance	-83.97	-83.30	-103.28	-124.38	-162.34	-202.09	-233.09	-256.61

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2008.

U.S. exports to China were 20 percent higher in the first half of 2008 compared with the same period in 2007, while imports from China were up only 6 percent.[6] However, America's import bill for goods from China is so huge that the rising exports have not dented America's overall trade deficit with China.

China's global exports from January to September 2008 rose 22.3 percent to $1.07 trillion, while imports were up 29 percent, at $893.1 billion.[7] Meanwhile, the price of China's imports has grown over the past year, due in part to higher costs for its petroleum imports. As a result, China's global trade surplus narrowed 2.6 percent year-on-year to $180.9 billion in the first three quarters of 2008.[8]

The composition of China's exports also is changing. Textiles and apparel accounted for most of China's global manufacturing surplus until 2004. But by 2007, China's surplus in electrical and nonelectrical equipment (including computers) and parts surpassed the surplus for textiles/apparel and, soaring by 60 percent so far in 2008, could produce a surplus this year that is half again as large as the surplus for textiles/apparel.[9] (See chap. 1, sec. 3, for an in-depth examination of the changing nature of U.S.-China trade.)

The cheaper dollar is one factor that already is helping reduce the rate of increase in the U.S. trade deficit with China and will continue to do so if Chinese authorities allow the appreciation of its currency, the renminbi (RMB), to respond to market forces. The declining dollar has made American exports to China more competitive and Chinese imports into America less so. But the change has been too small so far to halt the growing imbalance. The RMB has risen in value against the dollar by 18.5 percent in three years, during which time the trade imbalance between China and the United States has grown.[10] In the future, shifts in domestic spending in each country also may have an effect on the trade imbalance. America's real domestic demand has stagnated over the past year, whereas China's has risen by 10 percent.[11]

China's Exchange Rate Regime and Pursuit of Stability

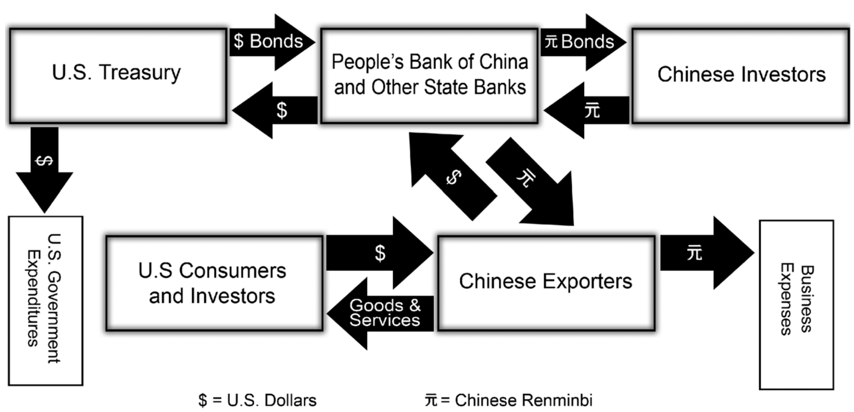
The U.S.-China trade relationship remains unbalanced. The U.S. trade deficit with China was about 32 percent of the total U.S. trade deficit in 2007—easily America's largest bilateral imbalance.[12] Economists and policymakers identify China's lower labor costs, intellectual property violations, and export and domestic subsidies as major contributors to this imbalance. China's manipulation of its currency also has contributed to the imbalance. While China has allowed its currency to appreciate by 18.5 percent over three years, the impact of the changes should not be overstated.

Although bilateral trade imbalances between the United States and other individual nations may be less of a concern if they are the result of free market forces, those, such as the U.S.-China imbalance, that result from deliberate economic policies undertaken by one of the trading parties are an issue. The U.S. current account deficit, combined with the federal budget deficit, causes considerable anxiety among both economists and foreign investors who worry that Americans will find it increasingly difficult to meet both principal and interest payments on such a large debt. The total federal debt burden of $10.2 trillion already is having a significant impact on economic growth, which will only increase in severity.[13]

While currency manipulation has been a useful tool in supercharging China's export machine, the practice has begun to cause problems for China's policymakers, including a persistent inflationary spiral. In simple terms, maintaining a low value for the RMB means that Chinese exports will be cheaper than they would be if the price of the currency were determined by market forces. The result is that Chinese goods are cheaper in the United States, and U.S. exports are more expensive in China, which provides China with an effective export subsidy and an incentive for U.S. companies to move their production to China. This problem also confronts U.S. exporters in other markets where they compete against Chinese products.

Economists' estimations of the degree to which the RMB is undervalued vary. The Peterson Institute for International Economics, for example, said in July 2008 that the RMB was still undervalued against the dollar by about 30 percent, even after the RMB had appreciated over 18 percent since moving to a "managed float" in July 2005.* [14] In contrast, most developed nations allow their currency to be traded on the open market and intervene only occasionally to try to temporarily influence short-term price swings. Some of China's Asian neighbors also keep their currencies undervalued against the dollar so as to remain competitive with China on exports. As China has done, Hong Kong, Taiwan, and Malaysia have purchased U.S. dollars in an effort to control the value of their currencies.

Currency Sterilization by the People's Bank of China



Beijing's tight management of the RMB involves the People's Bank of China issuing massive amounts of RMB-denominated bonds. First, the Chinese banks exchange dollars and other foreign

*Under considerable pressure from the U.S. administration and Congress, China has taken some small steps in this direction, all the while claiming that the government will not respond to pressure. In July 2005, China engineered a 2.1 percent overnight rise in the value of the RMB and announced a policy that would allow a "managed float" of the RMB within a very narrow daily trading band of 0.3 percent.

currency for RMB to obtain foreign exchange before it can go into circulation in China. Then, in a process designed to fight the inflation in China that otherwise would occur from so much RMB being added to the economy, the central bank issues RMB-denominated bonds. This "sterilization" process has not always been effective, and it has helped fuel inflation despite the central bank's efforts to absorb the excess money by selling bonds and raising bank reserve requirements.

Without the dollar purchases by the central bank, the supply of dollars in circulation in China would rise rapidly and quickly lose value relative to the RMB. Under present economic conditions, markets also would expect the RMB to rise if the "managed float" were abandoned. Critics of China's currency policy have suggested that China revalue its currency by fiat, much as it last did in July 2005, as an important step toward a free-floating exchange rate.

In the first seven months of 2008, China's central bankers sought to accelerate the RMB's appreciation to keep a tighter grip on inflation, allowing the currency to rise nearly 7 percent during the period.[15] But there has been a noticeable slowdown in the RMB's appreciation, with the RMB rising just 0.08 percent against the dollar in the third quarter of 2008, the smallest gain since the RMB moved away from a fixed exchange rate regime.[16] The reason is that meaningful appreciation, aimed at cutting inflation, created problems of its own, not the least of which are an increase in the price of China's exports and the so-called "hot money" inflows—highly liquid capital attracted by the expectation that the RMB will continue to rise. Left unchecked, the hot money inflows also could fuel inflation.[17]

The marked slowdown of currency appreciation has sparked speculation that Beijing has moved away from a policy of using the currency as a tool to counter inflationary pressures to a policy of using it as an instrument to promote export growth. Cheng Siwei, vice chairman of the standing committee of the National People's Congress and an influential voice in Chinese economic policy making, told the *Financial Times* that China does not "need to accelerate the appreciation of the RMB [because] the dollar will not weaken very much and may get stronger." [18]

China's Communist Party leadership sees its legitimacy and political monopoly as inextricably linked with the economy's good performance; therefore, any slowdown is unnerving and produces a response.[19] China's Politburo, the Communist Party's top decision-making body, said in a meeting in July 2008 that maintaining "steady" growth and fighting inflation were its top priorities.[20] Though economic growth in China is expected to slow from a high of 11.9 percent in 2007 to 9.7 percent in 2008, it is still remarkably high by global standards, and the slight dip in China's growth rate would not warrant a halt in RMB appreciation if the RMB were allowed to float freely.[*] [21] However, yielding to a host of industrial sectors that are "protected" by an undervalued RMB, China appears to have decided to pause appreciation.[22] Bank lending quotas

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*There are some suggestions that China's economic slowdown may extend beyond this year. The International Monetary Fund projects 9.3 percent growth in 2009. *See* IMF, *World Economic Outlook 2008* (Washington, DC: October 2008), p. 2. www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf.

were lifted by 5 percent; and additional bank loans are to be directed toward small- and medium-sized businesses and agriculture.[23]

The RMB undervaluation also limits the policy options of other countries—notably countries like Taiwan, Japan, and Malaysia that compete with China for export markets and do not want to see their exchange rates appreciate relative to the RMB. A coordinated appreciation of Asian currencies might be the only option, as no Asian country wants its currency to appreciate too much relative to the others for fear of being priced out of the global market by China's products. China's undervaluation, then, spurs other nations in the region to ensure artificially that their currencies remain undervalued, and the ultimate result is that the entire Asian region realizes large trade surpluses. This necessarily means other regions will have large trade deficits, inhibiting global adjustment.

The economic impacts of China's currency undervaluation and the concern about their effects on the global economy have not prompted the IMF to depart from its long-standing conclusion on the issue. In its half-yearly *World Economic Outlook 2008* report, the IMF said the RMB "remains substantially undervalued," an understated conclusion compared to a determination that the RMB is "fundamentally misaligned."[24] The latter conclusion would have indicated that China does not conform to guidelines prohibiting members from valuing their currency in a way that creates international instability and gives an unfair competitive advantage to its exporters, which would trigger significant IMF pressure on China to change its currency policy.[*][25]

In August 2008, the People's Bank of China launched a new exchange rate department.[26] This may indicate that China now sees the RMB exchange rate as a more important monetary policy instrument.[27] In the first half of 2008, for example, the People's Bank of China allowed the RMB to appreciate in order to stem inflation, but later, as the global economic situation began to deteriorate, it stopped the appreciation to boost exports. According to the bank's statement issued at that time, the new department's objectives will be tracking the foreign exchange market, implementing currency policy, formulating and implementing foreign exchange market regulations and controls, adjusting and controlling supply and demand in the domestic foreign exchange market, and seeking to create an offshore market for the RMB, in tandem with the process of internationalizing the RMB.[28]

An exchange rate office currently operates under the Monetary Policy Department of the People's Bank of China. After the reshuffle, the new exchange rate department will absorb the office of exchange rates and office of foreign exchange transactions but also may take on the duties of "analyz[ing] and predict[ing] the changes

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*The administration thus far has chosen not to bring a WTO case against China on the currency issue or to bring a formal complaint to the International Monetary Fund, which has some jurisdiction over international currency matters. Nor has the U.S. Department of the Treasury in its biannual reports on global currency manipulation been willing to cite China for that transgression. The administration has justified its decision not to cite China by pointing, in the 1988 law that requires the report, to a provision stating that a country can be cited only if it has deliberately manipulated its currency value to gain an export advantage. The administration argues that it cannot discern Chinese leaders' intent and therefore cannot cite China for currency manipulation. *See* U.S. House of Representatives, Committee on Ways and Means, Subcommittee on Trade, testimony of Deputy Assistant Secretary of the Treasury Mark Sobel, May 9, 2007. The 1988 law is The Omnibus Trade and Competitiveness Act of 1988.

of supply and demand in the foreign exchange market and provid[ing] the [People's Bank of China] with suggestions," which is currently the responsibility of the State Administration of Foreign Exchange (SAFE).[29] It is too early to tell if this new development will lead to bureaucratic rivalry or closer cooperation between SAFE and this new department or how it will impact SAFE's autonomy and investment strategies; what the impact will be on the People's Bank of China's sterilization operations; or if, in fact, these are preparations for more aggressive RMB reform.[30] Regardless, no decision about exchange rates can be made without State Council approval, so the true extent of changes, if any, in China's monetary policy, including interest rates, credit control, and sterilization, remains uncertain until further information becomes available.

Fannie Mae, Freddie Mac, and China's Holdings of U.S. Agency Securities

Due to its managed exchange rate, Chinese economic policy is still dependent upon the accumulation of large amounts of foreign exchange reserves—mostly dollars—which it then uses to purchase U.S. Treasuries and long-term securities of agencies such as the U.S. government-guaranteed (and now nationalized) mortgage holders Fannie Mae and Freddie Mac.* The United States welcomed these purchases because they helped to keep U.S. interest rates low.† By some estimates, as of June 2008, China held around $448 billion in agency bonds, or about 34 percent of the total $1.3 trillion held by foreign private investors and government institutions.[31] The People's Bank of China and other Chinese banks purchased Fannie Mae and Freddie Mac securities, even without an explicit U.S. government guarantee at the time, because the two mortgage giants paid slightly higher rates of interest than did U.S. Treasuries.

Even as the concerns over the health of the biggest U.S. mortgage finance companies intensified, foreign investors—China the biggest among them—were asking the U.S. Treasury to bolster Fannie Mae and Freddie Mac, according to news reports.[32] This caused U.S. officials to fear that divestment of bonds held by foreigners would push up interest rates in the United States.[33]

President Bush called China's President Hu Jintao in mid-September 2008 to talk about "what the administration was proposing . . . to restabilize the market," according to a White House spokesman.[34] A Chinese trade official confirmed that the call's purpose "was to ask for China's help to deal with this financial crisis by urging China to hold even more U.S. Treasury bonds and U.S. assets."

* Agency debt includes both that of official U.S. agencies such as the Tennessee Valley Authority and that of government-created enterprises such as Fannie Mae, because it has long been assumed by the market that such quasi-government agency debt is backed by the federal government, an assumption borne out by the response of the federal government to the credit crisis.

† Low U.S. interest rates have also made it much cheaper for individuals and households to borrow money. This, in turn, helped inflate the real estate bubble, which has led to the current collapse of the real estate market and credit crisis. *See* Niall Ferguson, "Rough Week, but America's Era Goes On," *Washington Post*, September 21, 2008.

Fannie Mae, Freddie Mac, and China's Holdings of U.S. Agency Securities—Continued

Since the collapse of the two mortgage companies, Chinese banks have been selling their housing agency bonds. The Bank of China,[35] China's fourth-largest commercial bank, has cut its portfolio of mortgage-backed securities issued by Fannie Mae and Freddie Mac by a quarter since the end of June 2008.[36] China Construction Bank Corp. said it had cut its Fannie and Freddie holdings to just above $2 billion by the end of July, down from $3.2 billion a month earlier. The Bank of Communications Co. sold all its $27 million in holdings in the two entities in early July.

U.S.-China Bilateral Dialogues

Through ongoing bilateral interaction like the high-level Strategic Economic Dialogue (SED) and the Joint Commission on Commerce and Trade, the United States is pushing China to accelerate the liberalization of its economy. According to U.S. Treasury Secretary Henry Paulson, by focusing on areas in which China's reform agenda intersects with U.S. interests, the SED "has found new and constructive ways to discuss some of the most important and contentious matters in the U.S.-Chinese economic relationship." These include trade imbalances, growth sustainability, and product safety.[37] (For a detailed look at the safety of China's seafood imports, see chap. 1, sec. 4.)

During the June 2008 SED, the United States and China agreed to launch negotiations for a bilateral investment treaty. Secretary Paulson said he believed "such a treaty would protect the large amount of U.S. investment in China and open up new opportunities for U.S. investors while encouraging more Chinese investment in the United States."[38] The first round of negotiations on the investment treaty was completed during September 2008. The U.S. administration said the United States wants the agreement also to include a national security exception that would allow the United States to continue imposing export controls and subjecting investments with possible national security implications to review by the Committee on Foreign Investment in the United States (CFIUS).[39]

One of the most critical issues will be how to deal with Chinese state-owned or state-controlled enterprises that are given preferential treatment by China's government.[40] China strictly limits investments by foreigners in certain sectors of its economy deemed essential for national security and economic prosperity, such as telecommunications, aviation, information technology, and heavy machinery. In addition, these sectors are heavily subsidized by the government and, among other benefits, enjoy access to land and loans at favorable terms. This would make it easier for Chinese government-owned companies to invest in the United States and to compete unfairly with U.S. firms.

Other key differences remain between the United States and China on what will be included in a bilateral investment treaty, including transparency in drafting and publishing regulations and free transfer of funds from profits.[41] One issue bound to be controversial is whether the treaty will cover foreign investments before they are made ("pre-establishment") or only after they are made ("post-establishment"), which determines how national treatment will be granted. Pre-establishment protection ensures that a host country's "commitment to grant national treatment on entry extends in principle to all foreign investors unless such investment is to take place in activities or industries specifically excluded by the host country in a treaty" and therefore is essential for foreign firms that now face more obstacles than Chinese domestic investors.[42] Post-establishment protection preserves the right of the host country to treat existing domestic and foreign investors differently, for example by applying "screening laws and operational conditions on admission."[43] China's other bilateral investment treaties cover only post-establishment, whereas U.S. investment treaties cover both, and full coverage is seen as critical by the U.S. government.[44]

Another issue that is likely to be controversial is the so-called "negative list approach" to identifying in the investment treaty limited exceptions or specific sectors. A negative list approach assumes that all laws and regulations are bound to the national treatment and other provisions of the investment treaty unless specifically exempted in an annex.[45] This ensures that the broadest possible scope of policies and practices is covered by the investment treaty. All previous U.S. bilateral investment treaties have used this approach, but China has yet to agree to its use.[46]

The 19th meeting of the Joint Commission on Commerce and Trade took place in September 2008, with participants reaching agreements on poultry exports and medical devices. The U.S. Food and Drug Administration (FDA) and China's General Administration of Quality Supervision, Inspection, and Quarantine jointly announced they will require only "one test, one report, one fee, and one factory inspection" for medical devices, which is expected to cut the medical device approval time "in half," according to the Joint Commission on Commerce and Trade fact sheet.[47] The Commission questions the efficacy of the Chinese inspection system in light of the long history of Chinese food safety scandals, the most recent of which is the contamination of Chinese milk with melamine. Some of the companies involved, including Sanlu, a leading Chinese dairy company, were exempt from inspection and monitoring by the government through a program that is based on the idea that companies that have scored well on past quality tests can be trusted to regulate themselves through internal inspection.[48]

China also agreed to lift "avian influenza-related bans" on poultry imports from Pennsylvania, Connecticut, Rhode Island, West Virginia, Nebraska, and New York and agreed to work jointly to address remaining bans on poultry from Virginia and Arkansas.[49] The U.S. Department of Agriculture (USDA) exchanged letters on agricultural cooperation with China's Ministry of Agriculture and together with China's General Administration of Quality Supervision, Inspection, and Quarantine updated a 2006 food safety Memorandum of Cooperation to establish clear guidelines for handling food safety issues pertaining to meat, poultry meat, or egg products.[50]

China and the Global Economy

Changes in Chinese Trade-related Laws

The Chinese government recently has adopted policies that may seek further restrictions on foreign access to China's markets, including new antimonopoly and patent laws. Although much depends on how these laws ultimately are implemented, they appear to favor some of the domestic companies that the Chinese government promotes as "national champions."[51] In addition, Chinese regulatory authorities allow little comment from foreigners in their rule-making procedures.[52]

The Antimonopoly Law

China's new antimonopoly law, which took effect in August 2008 after nearly 15 years of drafting, was hailed by the Chinese government as a milestone in the creation of an economy based on law. For many foreign companies, the new rules will be an improvement over the status quo, with its vague guidelines and unpredictable restrictions. The enforcement of new laws in areas such as price fixing and monopolistic behavior also could help force open domestic markets to outside competition.[53]

The antimonopoly law is based loosely on U.S. and European models and covers anticompetitive behavior and abuse of market dominance.[54] Some foreign companies, however, are concerned that some aspects of the antimonopoly law could be used selectively against them and not deployed equally against their Chinese rivals, depending on how China chooses to enforce the new law. Industries that "implicate national economic vitality and national security, which are controlled by state-owned enterprises, and . . . industries in which there are legal monopolies" will be supervised by the government and will be functionally exempt from the law, provided they do not abuse their dominant position.[55] In China, a dozen heavyweight, preferred industries, such as power generation, civil aviation, and iron and steel, primarily are comprised of large, state-owned enterprises and still dominate the economy, and this suggests the government remains disinclined to subject them to new scrutiny.[56]

According to the regulations, in their reviews of mergers and acquisitions the authorities will need to consider, among other factors, the parties' market shares and market power, market concentration and structure, likelihood of elimination or restriction of competition, and effects on consumers and other relevant business operators—all of which is fairly standard in other nations' laws. However, the law also requires consideration of the effect "on the development of the national economy and public interest," which directly raises the question of whether merger enforcement will be utilized for macroeconomic or even protectionist purposes.[57]

The law also provides that it is "applicable to the conduct of business operators to eliminate or restrict market competition by abusing intellectual property rights," a concept comparable to patent misuse under U.S. law.[58] However, many foreign companies fear that Chinese antitrust enforcers might be pressured by domestic industry to use this provision to restrain foreign intellectual property (IP) rights holders from enforcing their IP rights against Chinese competitors.[59]

Most specific guidelines for the antimonopoly law have not yet been released, but foreign companies worry that revenue thresholds in China will trap many transactions that have few implications for local competitors or consumers or that big companies anywhere in the world will have to wait for permission from Beijing before they can complete large global deals.[60] The law also could spell trouble for private equity deals, given the trend to bigger deals with more expansive impact. For example, a private equity fund in Europe involved in a buyout of an American company will have to worry about antitrust clearance in China, even if the deal is being conducted entirely outside China, if the transaction affects competition in China's domestic market.[61] The reach of the U.S. antitrust law similarly is not limited by geographical boundaries. Even in cases of foreign commerce that do not involve imports to the United States, the Foreign Trade Antitrust Improvements Act of 1982 states that anticompetitive conduct that "affects U.S. domestic or foreign commerce may violate U.S. antitrust laws regardless of where such conduct occurs or the nationality of the parties involved," provided this conduct had "a direct, substantial, and reasonably foreseeable effect" on domestic import or export commerce.[62]

Another major concern for multinationals is whether China's antitrust law is designed to protect domestic companies. Up until now, unlike foreign companies, Chinese companies have had no obligation to file for merger approval.[63] There also is concern about the confidentiality of the antitrust review process and whether any proprietary information disclosed by foreign companies may be abused. The government's enforcement and discretionary powers also remain uncertain. Many details will be filled in by regulations when they are promulgated, but the antimonopoly law's provisions leave considerable room for discretionary enforcement. This reduces predictability and is of even greater concern in China than it would be in other countries, such as the United States, because China's civil law system does not rely on case law precedents.[64]

Intellectual Property Rights and Patents

China has a history of flagrant violations of intellectual property rights (IPR). It now appears poised to revamp its IPR laws and regulations, which could either strengthen the protections or place another tool in Beijing's arsenal for promoting domestic industry by constraining the rights of foreign companies. In August 2008, the National People's Congress Standing Committee, China's top legislative body, began consideration of the Third Amendment to China's Patent Law. An important new proposal involves the adoption of an "absolute novelty" standard that will make it hard to obtain a Chinese patent for inventions that are already in use overseas (amended article 23 of China's Patent Law).[65] Another proposed revision (amended article 21 of China's Patent Law) would remove the statutory requirement for any Chinese entity or individual first to file applications in China for inventions made in China. The new patent law is of considerable interest to U.S. companies, and its implementation and effects on trade and investment bear further scrutiny.

The Labor Law

In January 2008, China implemented a new Labor Contract Law that aims to combat forced labor, withholding of pay, and other abuses by providing, among other things, for formal contracts and severance pay.[66] The law formalizes workers' rights concerning overtime hours, pensions, and layoffs. Employers are now required to give open-ended contracts to staff who have worked for 10 years or have completed two fixed-term contracts, and firms must pay fired workers a month's wages for every year they have worked.[67] The law also regulates overtime, dictating that for every extra hour an employee works, companies need to pay 1.5 times the normal rate on weekdays, double the normal rate on weekends, and triple the normal rate on national holidays.[68] Many important areas of internationally recognized workers' rights, however, are left unaddressed by the law, including freedom of association and collective bargaining.

The ultimate impact of the law depends on the way in which the government implements and enforces it, two areas where China's practices have been historically weak. While theoretically improving employees' work security and strengthening their rights, the law has sent firms scrambling to adapt or circumvent the law for fear of dramatic increases in business costs. Some companies have begun to urge, bribe, or coerce long-serving employees to take early retirement or voluntary severance and then rehire them on new contracts, thus resetting their length of service.[69] The most prominent example of this tactic was the move by Huawei, formerly a state-owned enterprise and now a privately owned telecommunications conglomerate based in Shenzhen, to require about 7,000 employees who had been with the company for more than eight years to "voluntarily resign."[70] In return, the employees received a lump sum of one month's salary for every year of employment, plus one additional month's salary, and were allowed to rejoin the company on a short-term contract.[71] Huawei dropped the plan, however, after the union controlled by the Chinese Communist Party, the All-China Federation of Trade Unions (ACFTU), said such practices ran counter to Beijing's goal of forging a "harmonious society."[72] The ACFTU is China's only union; independent unions are illegal.

Whether the costs of doing business in China will rise enough, as a consequence of the law, to drive away foreign business en masse remains to be seen, though some anecdotal evidence presented by the Federation of Hong Kong Industries suggests that while some companies are scaling back or shutting down their Chinese operations, others are moving to less-developed parts of China that offer tax breaks and other incentives in support of China's western development initiative.[73] The companies' calculus may be significantly altered, however, as a result of ACFTU demands that all companies allow "unions" to form by a September 30, 2008, deadline.[74]

New Currency Rules

China's undervalued currency and massive trade surpluses have produced nearly $2 trillion in foreign exchange reserves, $200 billion of which has been transferred to the China Investment Corporation, China's sovereign wealth fund (discussed in detail in chap. 1, sec. 2). Many overseas investors, attracted to the Chinese bonds by the expectation that the RMB will continue to appreciate, have made further investments in China, creating a self-sustaining speculation.

To slow down the growth in its hard currency reserves and curtail speculation, Beijing removed the requirement in August 2008 that Chinese companies exchange all their foreign currency in the local banking system.[75] This implies that the government will allow some of the foreign exchange the companies have received to leave China as portfolio investments abroad—a marked change of economic strategy. The implementation and impact of this change bear further examination.

Allowing companies to invest some of their foreign exchange earnings abroad may reduce pressure on the RMB to appreciate, because foreign currency inflows may moderate, and the government may not have to sterilize foreign currency inflows. The new rules also will simplify approvals for Chinese companies seeking to invest overseas, according to SAFE.[76] In addition, the government will gain more control over hot money inflows disguised as export earnings by allowing authorities to check invoices to ferret out speculative investments. SAFE will check banks' operations to make sure they abide by the new foreign exchange management rules.[77] Authorities also will be allowed to expand reporting requirements for financial institutions, which may enhance monitoring of illegal capital inflows.[78]

The WTO Cases

Prodded by the United States and other WTO members since it acceded to the WTO, China has taken many steps to reform its economy to meet its WTO obligations. It has implemented a broad set of commitments that required it to reduce tariffs, eliminate nontariff barriers, provide equal treatment to domestic and foreign-invested companies, improve market access for imported goods and services, increase transparency, and protect IPR.[79] Implementation of many of these requirements has been uneven.

At the root of the problem is China's continued pursuit of industrial policies that rely on excessive Chinese government intervention in the market through an array of trade-distorting measures.[80] These actions demonstrate that China has not yet fully embraced key WTO principles of market access, nondiscrimination, and transparency. Differences in views and approaches between China's central government and China's provincial and local governments also have continued to frustrate economic reforms, while China's difficulties in generating a commitment to the rule of law have exacerbated this situation.[81]

China's central government continues to implement industrial policies that protect a number of uncompetitive or emerging sectors of the economy from foreign competition. In many sectors, import barriers, opaque and inconsistently applied legal provisions, and limitations on foreign direct investment often combine to make it difficult for foreign firms to operate in China.[82] In addition, some ministries, agencies, and government-sponsored trade associations have renewed efforts to erect technical barriers to trade. Meanwhile, many provincial governments at times have strongly resisted reforms that would eliminate sheltered markets for local enterprises or reduce jobs and revenues in their jurisdictions.[83]

Lack of effective enforcement of intellectual property rules acts as a pervasive trade and investment barrier. Foreign creators of intellectual property lose hundreds of millions of dollars in revenue as a result of counterfeiting, making it impossible for many of them to operate profitably in China. Software provides an excellent case study. Compounding the losses of software companies resulting from lost sales, other foreign firms in entirely different industries also suffer as a result of pirated software. Chinese companies using pirated software spend far less than competitors that must purchase software to design and run industrial machinery, perform complex accounting, or accomplish myriad other functions.

The United States has cited China's restrictions on foreign financial information services and foreign financial services suppliers in bringing a complaint before the WTO. In March 2008, the United States claimed that China violates global trade rules by giving the Xinhua News Agency the right to issue annual licenses for overseas media organizations, barring them from directly distributing information and soliciting subscribers in China. Xinhua was given sole power in September 2006 to regulate news services that distribute financial information in China such as Bloomberg and Reuters—while it also is a direct competitor of such services.[84] Furthermore, in order to renew their licenses, China requires foreign financial information suppliers to provide to the Foreign Information Administration Center, a regulatory body within the Xinhua framework, detailed and confidential information concerning their financial information services, their customers, and their foreign suppliers.[85] This places the foreign firms in a position of extreme competitive disadvantage with Xinhua, which already enjoys a substantial home court advantage.

Creation of such de jure bottlenecks for financial information allows China further to tighten media controls in a nation where access to information already is severely curtailed by state censorship. Under the Chinese rules, media agencies can sell news and data to subscribers only via agents designated by Xinhua, which has the right to select information released by foreign organizations and to delete any materials that are deemed to undermine China's "social stability," endanger national security, or disrupt the country's economic order. In its WTO case, the United States, later joined by the European Union (EU) and Canada, claims that such measures breach Chinese pledges on national treatment and market access. The rules also break commitments China made when joining the WTO not to scale back existing rights for companies and to provide regulatory independence.[86] (See chap. 5 for a more detailed look at China's restriction of information services.)

In July 2008, China lost its first WTO case after a dispute panel ruled against Beijing's import tariffs for car parts. The case, brought in 2006 by the United States, the European Union, and Canada, alleged that China was using a combination of import duties and tax incentives to give an unfair advantage to domestic companies. China compelled foreign automakers to buy a quota of their components from local suppliers or pay more than double the standard import duty on parts if they made up more than half the finished vehicle. The import duty surcharge was equivalent to the tariff on imports of complete cars, typically 25 percent, compared with the usual 10 percent for car parts.[87] China appealed the WTO ruling in September 2008, and at the time this Report was completed, a final decision has not been made on the appeal.[88]

China's auto market is booming and is the world's second largest.[89] While joint ventures with big U.S. and European companies initially dominated the market, Chinese manufacturers have increased both domestic and export sales. As a protectionist device, the auto parts tariffs discouraged imports, built up China's domestic car manufacturing industry, and forced foreign parts manufacturers to relocate manufacturing to China. (See chap. 1, sec. 3, for more information on China's auto industry.)

Less than a month after losing the auto parts case, China introduced a new tax that will achieve much of what it originally wanted, albeit by a different route. Taking effect in September 2008, the new tax applies to gas-guzzling cars and ostensibly is intended to reduce fuel consumption and fight pollution. Both are admirable goals, but it surely is not a coincidence that most such cars are foreign made. The government says the new tax will encourage a shift to more fuel-efficient cars. It also will help domestic automakers, as they tend to make smaller cars, while large-engine trucks and increasingly popular sport utility vehicles are manufactured by foreign companies.[90]

In September 2008, China brought a WTO case against the United States regarding the U.S.' calculations of antidumping and countervailing duties in a number of trade remedy cases involving circular welded steel pipe, light-walled rectangular pipes, off-road tires, and laminated woven sacks.[91] China challenged several aspects of the U.S. countervailing duty methodology, including whether its state-owned enterprises meet the definition of "public bodies," and argued that the United States failed to prove its case.[92] The U.S. Trade Representative responded that it is "fully confident in [U.S.] trade remedy laws and will vigorously defend the WTO consistency of these laws."[93]

U.S. trade officials are considering challenging China on two additional aspects of the U.S.-China trade relationship—one related to farm taxes and subsidies and the other to steel. In the former case, in an August 2008 letter to the WTO Committee on Agriculture, the United States challenged China to justify the legality of its tax, subsidy, and export rules for farm products such as pork and wheat—specifically article 86 of China's Enterprise Income Tax Law that "wholly exempts agricultural producers from the payment of enterprise income taxes with regard to the 'rearing of livestock,' including pork."[94] The United States also alleges that China exempts many agricultural products from the 13 percent value-added tax (VAT) normally applicable to agricultural products. In particular, "sales of agricultural commodities produced and sold by farmers in China such as wheat, cotton, and corn, [and] sales of agricultural inputs produced and sold in China such as seed, pesticides, herbicides, agricultural machinery, and certain fertilizers," are exempted from the VAT.[95] However, when these same products are imported, "they are assessed the VAT at the rate of 13 percent," which violates nondiscrimination principles.[96]

A WTO dispute settlement panel has issued an interim ruling in October 2008 on another case brought against China by the United States in 2007 (with Canada, the European Union, Japan, and Mexico joining the consultations), which challenged China's enforcement of intellectual property rights. The panel ruled against the United States on a key point of what constitutes "commercial scale" piracy but ruled against China's enforcement regime on two other points.[97] The panel ruled that the United States failed to provide substantial evidence to show that the kinds of infringing activities in China exempt from criminal prosecution actually qualify as "commercial scale" piracy.[98] On two other points of contention the panel found that China violates WTO rules by auctioning off counterfeit goods the government has intercepted after removing the infringing trademark and by denying copyright protection to works that have not been approved by Chinese censors, which basically has made it legal for counterfeiters to distribute pirated copies of such works.[99] This decision is not final, as both parties to a dispute may file comments with the dispute settlement panel after reviewing the interim report.

In September 2008, the *Financial Times* reported that the United States is close to filing a WTO case against China challenging export restrictions on raw materials used in steel making and other industries.[100] According to the news report, the United States is expected to argue that Chinese export quotas and taxes on raw materials used in steel production "artificially deflate domestic prices and inflate global prices," granting domestic producers an unfair advantage over the U.S. ones.[101] The United States has questioned China's actions in this area in the past as WTO violations. As with the farm tax and subsidy case, the United States has not yet requested formal consultations, the first step in the WTO dispute settlement process.

There is another pending WTO case against China filed by the United States. The United States has challenged China's alleged constrained market access for U.S. films, books, journals, music, and other media (the European Union has joined consultations). As of the date this Report was completed, the director general has composed the panel in this case, but no report has been issued.

Breakdown of the Doha Trade Talks

As the WTO's Doha Round of trade talks, now in its seventh year, broke down in late July, China emerged as a central player in global economic decision making. Since joining the WTO in 2001, China has kept a low profile, generally siding with developing countries. It had, however, been critical of the United States for invoking safeguard quotas to prevent an increase in imports of Chinese textiles that threatened American manufacturers. But in the later stages of the Doha Round, China allied itself with India to demand last-minute concessions on safeguard rules for agriculture in sectoral talks on farm trade. India and China insisted that developing countries be allowed to impose safeguard tariffs on food imports to protect farmers in poor countries, since they have little access to credit, fertilizers, advanced crop strains, clean water, and mechanized farming methods and can be harmed by international trade.[102] The United States and other agricultural exporters refused to accept the Indian and Chinese position. As a result, the talks collapsed amid charges that China had reneged on previous commitments to support U.S. and European proposals on the key issue of agricultural trade. U.S. trade negotiator David Shark said that India and China threw the Doha Round "into the gravest jeopardy of its [. . .] life," but China's trade negotiator, Chen Deming, dismissed the accusation as "groundless."[103]

China's action comes at a time of rising food prices and concerns in developing nations over food security. Ensuring that its farmers can produce most of China's food has become an increasingly important focus for the Chinese government. Speaking at the July 2008 meeting in Japan of the leaders of the G–8 nations, Chinese President Hu Jintao said that "China attaches great importance to agriculture and especially the food issue, [. . .] and pursues a food-security policy of relying on domestic supply, ensuring basic self-sufficiency, and striking a balance through appropriate import and export."[104]

China "had never played an active role in the Doha talks, but it is now aggressively challenging the global trading system," said C. Fred Bergsten, director of the Peterson Institute for International Economics.[105] China surprised rich nation negotiators by insisting that poorer nations retain the right to raise tariffs on imports of farm goods in order to protect subsistence farmers in the poorer nations from devastating increases in imports. This ability is a staple of trade law, but European and U.S. negotiators said that China was setting the trigger price for such relief far too low and the potential tariff rates too high. China's insistence on protecting subsistence farmers from allegedly ruinous competition upset a delicate compromise that seemed to be leading the unwieldy talks to a final conclusion: In return for greater access to developing nations' markets for their agricultural exports, the U.S. and European exporters would agree to limit the huge government subsidies to their farmers that can make imported food cheaper in the poor nations of Africa, Asia, and South America than domestically grown crops such as rice, corn, and cotton.

Consequences of the Global Market Turmoil

Grappling with rising labor costs, volatile fuel prices, and the strengthening Chinese currency, Chinese economic markets are not immune from the woes of the current global economic slowdown, although the effects have been mild compared to what has occurred in the United States and other developed nations. China's financial system remains relatively closed—with inflows and outflows of capital strictly controlled, the banking sector largely state owned, and nearly $2 trillion of foreign exchange reserves—and thus insulated from the credit crunch. China's global exports expanded by 22 percent in the first half of 2008.[106] Though this is down slightly from a 28 percent growth rate in the same period of 2007, next year

China is expected to overtake the United States as the world's largest producer of manufactured goods, four years earlier than forecast as recently as last year, according to Global Insight, an economics consultancy.[107]

Despite an enviable growth rate, China's leadership is concerned that higher costs will bring about a severe slowdown in consumption of Chinese goods abroad. It is expected to take steps intended to prop up the rate of the nation's economic expansion. Already in August 2008, Beijing trimmed export taxes imposed on garment manufacturers, and the central bank has eased limits on lending by Chinese banks to make it easier to invest in that sector. While inflation was a worry earlier this year, peaking at 8.7 percent in February, consumer prices grew by a relatively modest 4.6 percent in September 2008.[108] With inflation appearing to ease, Beijing is likely to step up government spending again to boost growth.[109]

An increase in the textile export tax rebate in August 2008, for example, and an additional increase in October 2008, represent a complete reversal of earlier, long-term initiatives to shift China away from low-end manufacturing and move any low-scale labor from the coast to the interior. To slow the nation's ballooning growth, the government had reduced the rebate rates of the value-added tax for more than 2,800 products in 2007, including hundreds of textiles and garments.[110]

However, the textile sector is a huge employer, with low margins that have been worn away by currency appreciation and rising input costs, and it now has won additional tax breaks.[111] In contradiction to its own policy of moving away from low-cost manufacturing, China actually has raised the tax rebate on a range of textiles to 14 percent from 11 percent, a shot in the arm for exporters struggling with a stronger RMB, weakening demand, and rising costs of inputs and labor.[112]

In October 2008, tax rebates also were increased for other exporting sectors, including toys (increased to 14 percent), plastics (increased to 9 percent), furniture (increased to between 11 percent and 13 percent), ceramics (increased to 11 percent), and drugs to treat AIDS. Export rebates for some other medicines and electrical goods such as sewing machines, electric fans, and electronic parts for machine tools will be raised to between 9 and 13 percent.[113]

In September 2008, after years of tightening monetary policy to fight inflation, China reversed course and cut interest rates for the first time in six years and then cut them again less than a month later in tandem with the Federal Reserve, the European Central Bank, and other central banks.[114] It also lowered the reserve ratios for most smaller banks as export growth slowed, real estate prices weakened, and China's stock market fell more than 60 percent since January 2008.[115] The People's Bank of China said that the goal of the policy shift was to "solve prominent problems in the current economic operation [. . .] and ensure a steady, rapid and sustained development."[116] However, the People's Bank of China did not lower the reserve requirements for the nation's six largest banks—Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, the China Construction Bank, the Bank of Communications, and the Postal Savings Bank—that must hold large sums of reserves so that the central bank can continue buying foreign exchange, thus limiting the appreciation of the RMB against the dollar.[117] It appears, therefore, that China's government wants to continue to rely on exports to grow its economy.

Conclusions

- China's trade surplus with the United States remains large, despite the global economic slowdown. The U.S. trade deficit in goods with China through August 2008 was $167.7 billion, which represents an increase of 2.4 percent over the same period in 2007. Since China joined the WTO in 2001, the United States has accumulated a $1.16 trillion goods deficit with China and, as a result of the persistent trade imbalance, by August 2008 China had accumulated nearly $2 trillion in foreign currency reserves. China's trade relationship with the United States continues to be severely unbalanced.
- The U.S. current account deficit causes considerable anxiety among both economists and foreign investors who worry that future taxpayers will find it increasingly difficult to meet both principal and interest payments on such a large debt. The total debt burden already is having a significant impact on economic growth, which will only increase in severity.
- China's currency has strengthened against the U.S. dollar by more than 18.5 percent since the government announced in July 2005 it was transitioning from a hard peg to the dollar to a "managed float." Starting in July 2008, however, the rate of the RMB's appreciation has slowed, and there are some indications this may be due to the Chinese government's fear that a strong RMB will damage China's exports. China's RMB remains significantly undervalued.
- China continues to violate its WTO commitments to avoid trade-distorting measures. Among the trade-related situations in China that are counter to those commitments are restricted market access for foreign financial news services, books, films and other media; weak intellectual property protection; sustained use of domestic and export subsidies; lack of transparency in regulatory processes; continued emphasis on implementing policies that protect and promote domestic industries to the disadvantage of foreign competition; import barriers and export preferences; and limitations on foreign investment or ownership in certain sectors of the economy.
- Over the past year, China has adopted a battery of new laws and policies that may restrict foreign access to China's markets and protect and assist domestic producers. These measures include new antimonopoly and patent laws and increased tax rebates to textile manufacturers. The full impact of these laws is not yet known, particularly whether they will help or hinder fair trade and investment.
- In 2008, China emerged as a stronger power within the WTO as it took a more assertive role in the Doha Round of multilateral trade talks, working with India and other less-developed nations to insist on protection for subsistence farmers.